INVESTMENT IMPLICATIONS

OF

S. 1527

THRIFT SAVINGS PLAN

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FIRST, LET ME INTRODUCE MYSELF. I AM JON FOSSEL, SENIOR VICE PRESIDENT OF ALLIANCE CAPITAL MANAGEMENT, ONE OF THE WORLD'S LARGEST INVESTMENT MANAGEMENT ORGANIZATIONS. AT ALLIANCE, WE MANAGE OVER $23 BILLION OF OTHER PEOPLE'S MONEY, THE VAST MAJORITY OF WHICH, SOME $16 BILLION IS FOR CORPORATE PENSION PLANS AND FOR STATE AND LOCAL GOVERNMENT RETIREMENT SYSTEMS. OUR CLIENTS INCLUDE 31 OF FORTUNE MAGAZINE'S TOP 100 COMPANIES, RANGING FROM AMERICAN BRANDS TO WARNER LAMBERT AND 50 GOVERNMENT RETIREMENT SYSTEMS FROM THE HAWAII EMPLOYEES RETIREMENT SYSTEM TO THE MAINE STATE RETIREMENT SYSTEM, AND HERE IN THE WASHINGTON AREA, THE DISTRICT OF COLUMBIA TEACHERS, POLICE AND FIREFIGHTERS AND JUDGES RETIREMENT BOARD AND THE STATE OF MARYLAND. OUR LIST OF CLIENTS AND THE ASSETS THEY ENTRUST TO OUR MANAGEMENT HAVE GROWN SUBSTANTIALLY OVER THE YEARS, IN LARGE PART BECAUSE OUR LONG-TERM INVESTMENT RESULTS HAVE CONSISTENTLY MET OR EXCEEDED OUR CLIENTS EXPECTATIONS. FOR EXAMPLE, DURING THE PAST TEN YEARS, OUR EQUITY ACCOUNTS ACHIEVED A COMPOUND ANNUAL RETURN OF 17.3%. THESE RESULTS COMPARE VERY FAVORABLY WITH THE CPI WHICH INCREASED 7.3% PER YEAR DURING THE SAME PERIOD, AND THE S & P "500" INDEX WHICH RETURNED 14.8% ANNUALLY.

IN ADDITION TO MY 21 YEAR INVESTMENT CAREER, I SPENT TWO TERMS IN THE NEW YORK STATE ASSEMBLY WHERE I SERVED ON THE WAYS & MEANS COMMITTEE AND THE GOVERNMENT OPERATIONS COMMITTEE, TWO YEARS AS ITS RANKING MEMBER. MY INTIMATE INVOLVEMENT WITH FISCAL, BUDGET AND RETIREMENT ISSUES IN THE NEW YORK STATE LEGISLATURE HAS GIVEN ME A FAR DEEPER UNDERSTANDING OF THE COMPLEXITY OF THE RETIREMENT ISSUES FACING CONGRESS TODAY.

MY ASSIGNMENT FOR THE REMAINING 15 MINUTES IS TO SHARE WITH YOU MY THOUGHTS ON THE INVESTMENT IMPLICATIONS OF CERTAIN PROPOSED CHANGES IN THE FEDERAL RETIREMENT SYSTEM REQUIRED BY THE SOCIAL SECURITY ACT AMENDMENTS OF 1983. I SHOULD POINT OUT THAT MY VIEWS DO NOT NECESSARILY REPRESENT THE VIEWS OF MY FIRM, BUT THEY DO PROBABLY REFLECT A BROAD CONSENSUS OF INVESTMENT THINKING TODAY.

INTRODUCTION

THE NEED FOR CONGRESS TO ADDRESS ITSELF TO ALTERNATIVES TO THE CURRENT CIVIL SERVICE RETIREMENT SYSTEMS IS ABUNDANTLY CLEAR TO NEARLY EVERY INTERESTED PARTY. THE ACTIONS TAKEN BY CONGRESS PRIOR TO JANUARY 1ST 1986 COULD HAVE A VERY MAJOR IMPACT ON:

- CURRENT AND FUTURE PARTICIPANTS.
- CURRENT AND FUTURE BENEFICIARIES.
- THE ATTRACTIVENESS OF FEDERAL EMPLOYMENT FOR EXISTING AND NEW WORKERS.
- THE FEDERAL BUDGET AND TAXES.
- THE U. S. FINANCIAL MARKETS.
- GROWTH IN THE U. S. ECONOMY.

IN OTHER WORDS, THE STEVEN'S-ROTH PROPOSAL, OR WHATEVER ALTERNATIVE IS FINALLY ADOPTED, WILL HAVE A VERY BROAD AND LONG-LASTING EFFECT ON EACH AND EVERY AMERICAN, NOT ONLY FOR TODAY, BUT FOR GENERATIONS TO COME.

I WOULD LIKE TO LOOK AT THE INVESTMENT IMPLICATIONS FROM TWO QUITE DIFFERENT PERSPECTIVES. FIRST, WHAT ARE THE IMPLICATIONS OF EACH OF THE PROPOSED ACT'S MAJOR ELEMENTS.

AMONG THESE ARE:

- PRIVATE SECTOR INVESTMENTS, AND I WOULD ADD, EXPANDED PUBLIC SECTOR INVESTMENTS VS. THE PRESENT SOLE USE OF SPECIAL TREASURY ISSUES.

- DEFINED BENEFIT AND THRIFT PLAN VS. THE CURRENT DEFINED BENEFIT PLAN.

- STRUCTURAL ISSUES SUCH AS THE ROLE OF THE PENSION BOARD OF TRUSTEES.

- POLITICAL AND POLICY ISSUES SUCH AS INVESTING FOR "SOCIAL" PURPOSES.

SECONDLY, I WOULD LIKE TO COMMENT ON THE INVESTMENT IMPLICATIONS OF THE PROPOSED ACT IN TERMS OF ITS EFFECT ON THE MAJOR INTERESTED PARTIES.

AMONG THESE ARE:

- THE FEDERAL EMPLOYEE, ESPECIALLY THE NEW EMPLOYEE.

- THE FEDERAL GOVERNMENT AS THE EMPLOYER.

- THE ECONOMY AND THE FINANCIAL MARKETS.

PRIVATE SECTOR INVESTMENTS

LET ME GO BACK NOW TO THE MAJOR ELEMENTS OF THE ACT AND EXAMINE THE INVESTMENT IMPLICATIONS OF UTILIZING PRIVATE SECTOR INVESTMENTS INSTEAD OF THE CURRENT PRACTICE OF ONLY BUYING AND HOLDING SPECIAL TREASURY SECURITIES.

FIRST, LET ME SAY THAT PRIVATE VS. PUBLIC INVESTMENTS IS NOT THE RIGHT ISSUE. THE RIGHT ISSUE IS: "WHAT INVESTMENT POLICY IS BEST SUITED TO PROVIDING APPROPRIATE RETIREMENT BENEFITS TO FEDERAL RETIREES AT THE LEAST COST TO THE EMPLOYER AND CURRENT PARTICIPANTS, AT AN ACCEPTABLE LEVEL OF RISK".

IN MY OPINION, THE ANSWER TO THAT QUESTION IS THAT MOST INVESTMENTS INCLUDING: SPECIAL ISSUES, PUBLICLY TRADED TREASURY ISSUES, OTHER FEDERAL AGENCY ISSUES, CORPORATE BONDS, COMMON STOCKS, REAL ESTATE, VENTURE CAPITAL AND PROBABLY OTHER ALTERNATIVES, ARE APPROPRIATE HOLDINGS

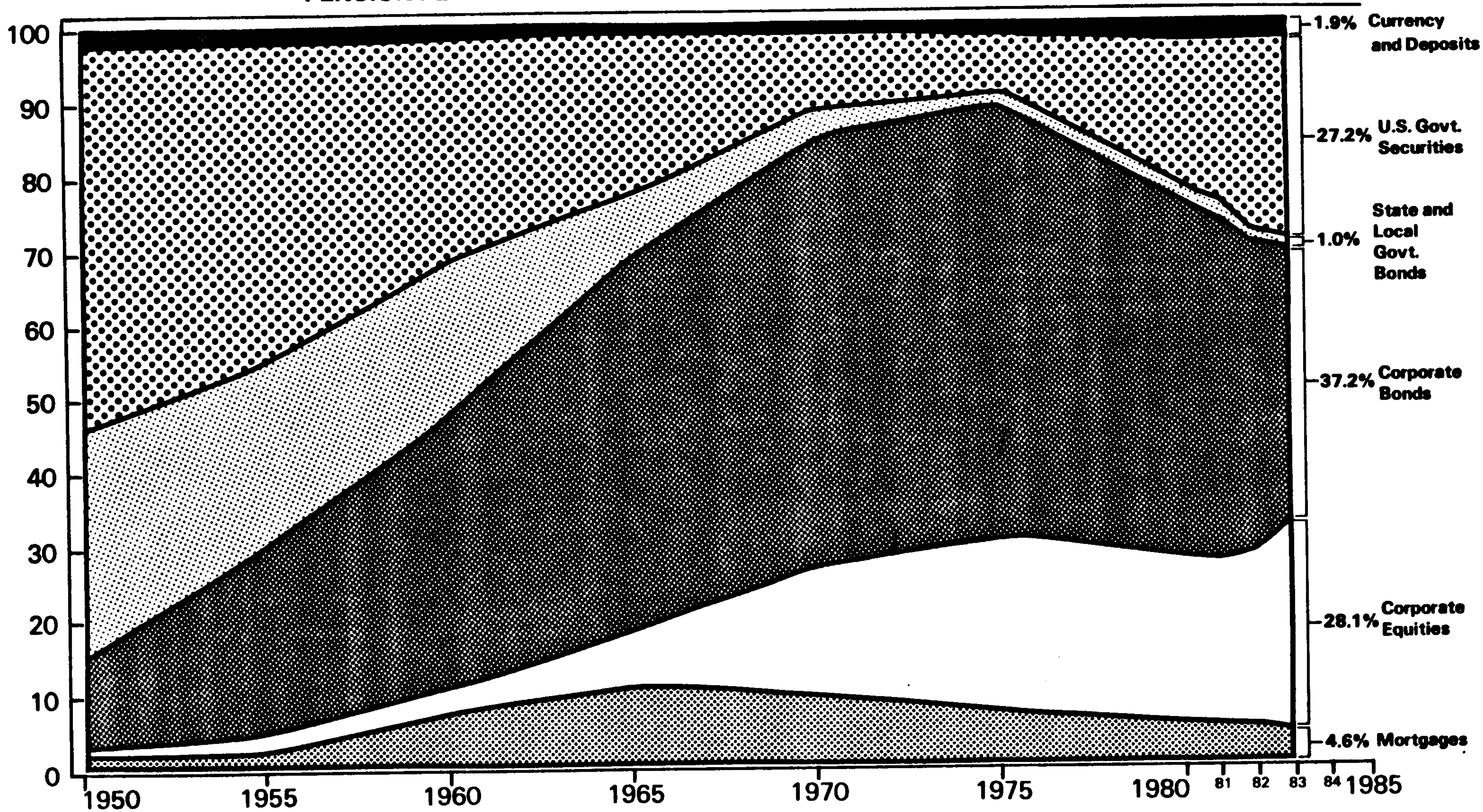
FOR A RETIREMENT SYSTEM AS LARGE AND WITH AS LONG TERM A PERSPECTIVE AS THE FEDERAL GOVERNMENT'S. THE PROPER MIX OF THE VARIOUS INVESTMENTS WILL DEPEND ON THE CHANGING MIX OF THE WORKFORCE, ACTUARIAL ASSUMPTIONS, THE NATURE OF THE PLAN OR PLANS, THE PREFERENCE OF THE EMPLOYEES, CHANGING ECONOMIC AND INVESTMENT TRENDS, AND THE PROSPECTIVE REAL RETURNS AND RISK ASSOCIATED WITH EACH ALTERNATIVE.

THE FOLLOWING CHART (SLIDE I) SHOWS HOW THE INVESTMENT MIX OF AMERICA'S STATE AND LOCAL GOVERNMENT PENSION PLANS HAVE CHANGED OVER THE PAST 33 YEARS. MUCH OF THE CHANGE IS SECULAR IN NATURE SUCH AS THE DECLINE IN STATE AND LOCAL GOVERNMENT BONDS BUT MUCH IS ALSO UNDOUBTEDLY IN RESPONSE TO CHANGING MARKET AND INVESTMENT RETURN CONDITIONS. I MIGHT NOTE THAT THE TOTAL ASSETS HELD BY THESE PUBLIC PENSION PLANS CURRENTLY EXCEEDS $300 BILLION.

A SIMILAR CHART FOR CORPORATE PENSION PLANS WOULD SHOW A VERY DIFFERENT ASSET MIX BUT SIMILAR LONG-TERM TRENDS. AS THE COST OF PROVIDING APPROPRIATE RETIREMENT BENEFITS HAS ESCALATED, PLAN SPONSORS AND THEIR INVESTMENT MANAGERS HAVE BECOME MORE SENSITIVE TO ENHANCING RETURNS WHILE AT THE SAME TIME MAINTAINING RISK AT ACCEPTABLE LEVELS. I SAY ACCEPTABLE LEVELS INSTEAD OF SAYING "MINIMIZING RISK" BECAUSE BY DEFINITION A RETIREMENT SYSTEM SHOULD HAVE A LONG-TERM INVESTMENT PERSPECTIVE. EMPLOYEES AND/OR EMPLOYERS MAKE CONTRIBUTIONS OVER A VERY LONG NUMBER OF

SLIDE I

PERCENTAGE OF STATE AND LOCAL GOVERNMENT PENSION PLANS INVESTED AMONG VARIOUS ASSETS, 1950 - 1983*



* All values shown are at cost (except corporate equities). Corporate equities are shown at market value.

Source: Federal Reserve Board Flow of Funds Accounts.

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YEARS AND BENEFICIARIES USUALLY RECEIVE BENEFITS FOR MANY YEARS. THEREFORE, IN ORDER TO IMPROVE BENEFITS AND/OR REDUCE COSTS THROUGH ATTAINMENT OF HIGHER RETURNS THE ASSUMPTION OF SOME SHORTER-TERM VOLATILITY (OR RISK) IS PERFECTLY APPROPRIATE (AND PRUDENT).

THE FOLLOWING TABLE (SLIDE II) ILLUSTRATES THE COMPOUND ANNUAL RETURN ACHIEVED FROM THE FOUR MAJOR CLASSES OF INVESTMENT ASSETS OVER THE PAST 59 YEARS.

59 YEARS WHICH INCLUDED:

- 2 DECLARED WARS
- 1 DEPRESSION
- MORE THAN A DOZEN RECESSIONS
- AN ENERGY CRISIS
- 1 PRESIDENTIAL ASSASSINATION AND 1 NEAR MISS
- DEFLATION, INFLATION, STAGFLATION AND NOW DISINFLATION

IN OTHER WORDS, HARDLY A PLACID PERIOD.

SLIDE II

STOCK, BONDS, RISK FREE ASSETS, & INFLATION
COMPOUND GROWTH RATES, 1926-[illegible] 6/30 1985

	NOMINAL	REAL
COMMON STOCKS (S&P 500)	~~9.0%~~ 9.7%	6.6%
LONG-TERM CORPORATE BONDS	~~4.2%~~ 4.6%	~~1.2%~~ 1.5%
LONG-TERM GOVERNMENT BONDS	~~3.5%~~ 3.9%	~~0.5%~~ 0.8%
TREASURY BILLS	~~3.2%~~ 3.4%	~~0.2%~~ 0.3%
INFLATION	~~3.0%~~ 3.1%	—

Source: University of Chicago

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AND YET THE RISKIEST (OR MOST VOLATILE) ASSET, COMMON STOCKS, ACHIEVED THE HIGHEST RETURN BY THREE TIMES AS MUCH PER YEAR AS U. S. TREASURY BILLS, AN OSTENSIBLY RISK-FREE INVESTMENT, WHICH IS ALSO A VIRTUALLY RETURN FREE INVESTMENT, IN REAL TERMS.

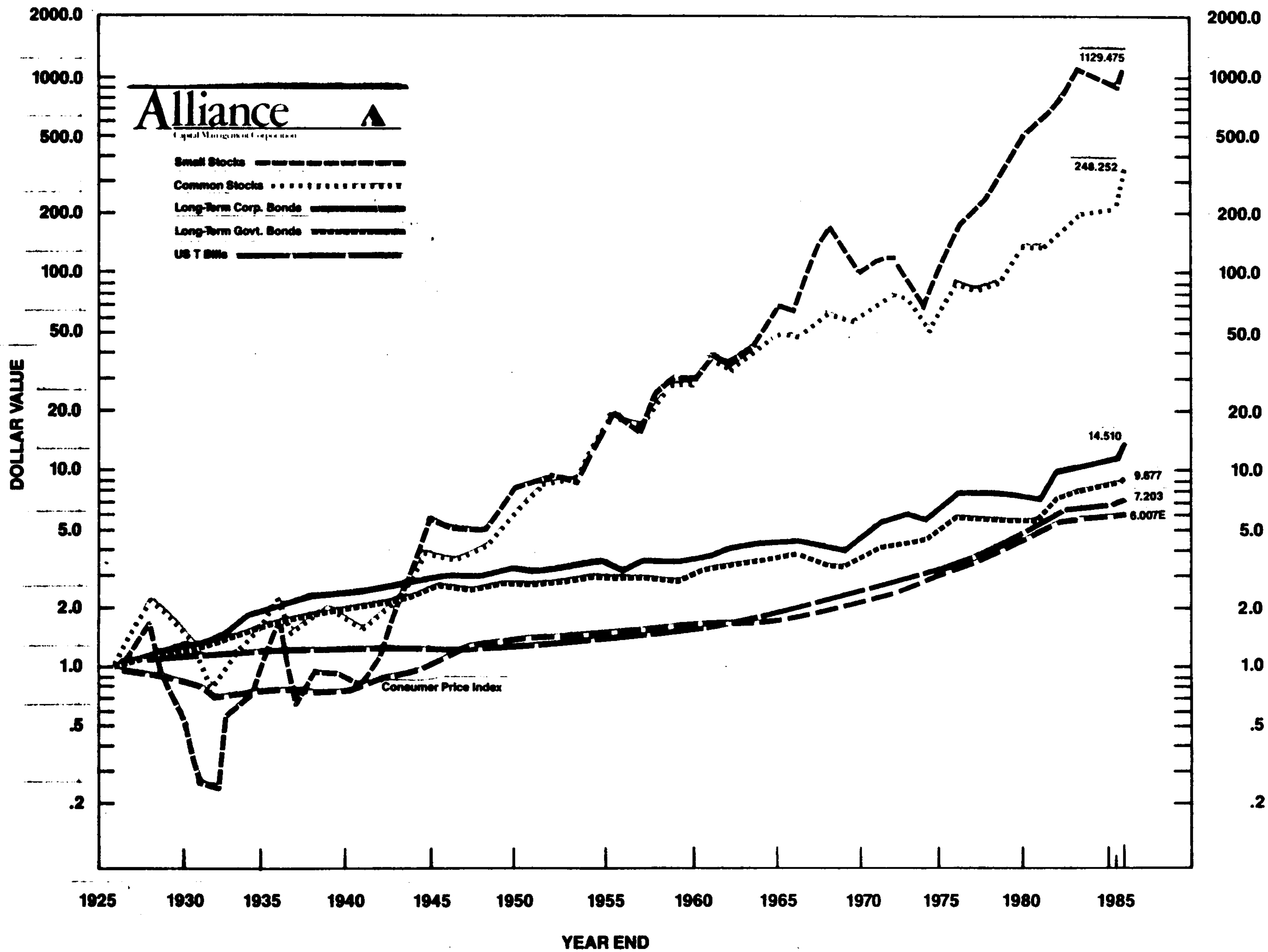
THE NEXT CHART (SLIDE III) SHOWS DRAMATICALLY THE LONG-TERM IMPACT OF COMPOUNDING A GIVEN DOLLAR OF INVESTMENT AT A HIGH RATE.
THE CHART SHOWS THAT ONE DOLLAR INVESTED IN COMMON STOCKS AT THE END OF 1925 WOULD HAVE BEEN WORTH $248.25 BY JUNE 30TH 1985 WHEREAS THAT SAME DOLLAR INVESTED IN LONG-TERM CORPORATE BONDS WOULD BE WORTH $14.51, $9.68 IF IN LONG-TERM GOVERNMENT BONDS AND $7.20 IF IN TREASURY BILLS. OBVIOUSLY, THE IMPACT OF HIGHER RETURNS HAS SIGNIFICANT POSITIVE IMPLICATIONS FOR EMPLOYEE AND EMPLOYER ALIKE, ESPECIALLY SINCE THE PURCHASING POWER OF THE DOLLAR WAS CUT BY NEARLY 85%.

THE GRAPH, HOWEVER, SHOWS SOMETHING ELSE AS WELL, AND THAT IS HOW MUCH MORE VOLATILE THE SHORTER-TERM RETURN FROM STOCKS HAS BEEN WHEN COMPARED TO LESS RISKY INVESTMENT ALTERNATIVES. OVER THIS PERIOD, THE ANNUAL RETURN FOR STOCKS RANGED FROM +54% IN 1933 TO -43% IN 1931. WHEREAS LONG-TERM GOVERNMENT BOND RETURNS RANGED FROM +30% IN 1932 TO -16% IN 1946.

ALL CLASSES OF ASSETS EXCEPT SHORT-TERM TREASURY BILLS HAD AT LEAST ONE <u>TEN</u> YEAR PERIOD WHEN <u>BOTH</u> NOMINAL AND REAL RETURNS WERE NEGATIVE.

SLIDE III

WEALTH INDICES OF INVESTMENT IN THE U.S. CAPITAL MARKETS 1926—1983



Source: Stocks, Bonds, Bills & Inflation: 1984 Yearbook R.G. Ibbotson Associates, Chicago, 1984

HOWEVER, A DIFFERENT PICTURE EMERGES WHEN TWENTY YEAR HOLDING PERIODS ARE EXAMINED. AS THE FOLLOWING TABLE (SLIDE IV) SHOWS, EVERY CLASS OF ASSET HAD A POSITIVE NOMINAL RETURN FOR ANY TWENTY YEAR PERIOD.

THIS TABLE IS DRAMATIC EVIDENCE OF THE HIGHER LONG-TERM RETURNS THAT IS LIKELY TO BE FOUND IN MORE RISKY (THAT IS MORE VOLATILE ASSETS) AND ALSO SHOWS THAT OVER LONGER TIME PERIODS THE RISK OF NEGATIVE RETURNS FROM COMMON STOCKS, THE MOST VOLATILE ASSETS, HAS BEEN WELL WITHIN ACCEPTABLE AND PRUDENT LIMITS IN FACT, THERE HAVE BEEN 20 YEAR PERIODS WHEN THE ALLEGEDLY SAFEST INVESTMENTS, TREASURY BILLS, HAVE LOST MONEY IN REAL TERMS. THIS HAS NOT BEEN THE CASE WITH STOCKS.

WHILE THE PRECEDING ANALYSIS IS HISTORICAL, IT MIGHT BE INSTRUCTIVE TO TAKE A LOOK INTO THE FUTURE THROUGH THE EYES OF 126 OF THE COUNTRY'S LARGEST STATE AND LOCAL GOVERNMENT PENSION FUND OFFICIALS.

THE TABLE (SLIDE V) SHOWS THAT FOR THE NEXT 5-10 YEARS, THESE FUNDS EXPECT THE HISTORICAL RELATIONSHIP BETWEEN RISK AND RETURN TO BE MAINTAINED, WITH THE MORE VOLATILE INVESTMENTS, EMERGING GROWTH STOCKS, TO OFFER FAR HIGHER RETURNS THAN LOW RISK INVESTMENTS SUCH AS TREASURY BILLS. I MIGHT ADD A PERSONAL OPINION HERE, WHICH IS THAT I BELIEVE THE TOTAL RETURN REALIZED BY LONG-TERM HIGH YIELDING, HIGH QUALITY BONDS WILL EXCEED RETURNS FROM COMMON STOCKS OVER THE NEXT SEVERAL YEARS ON A RISK

SLIDE IV

COMPOUND ANNUAL RATES OF RETURN OVER BEST/WORST 20 YEAR PERIODS (1926-1983)

	Best 20 Years		Worst 20 Years	
	Nominal	Real	Nominal	Real
Small Stocks	21.1% (1942-61)	17.2% (1942-61)	5.7% (1929-48)	4.0% (1929-48)
Common Stocks	16.9% (1942-61)	13.0% (1942-61)	3.1% (1929-48)	0.8% (1962-81)
Long Term Corporate Bonds	5.5% (1926-45)	5.4% (1926-45)	1.3% (1950-69)	-2.7% (1962-81)
Long Term Government Bonds	4.7% (1926-45)	4.6% (1926-45)	0.7% (1950-69)	-3.1% (1962-81)
Treasury Bills	6.1% (1962-81)	1.0% (1952-71)	0.4% (1931-50)	-3.1% (1933-52)
Inflation	5.9% (1962-81)		0.1% (1926-45)	

SOURCE: ***Stocks, Bonds, Bills and Inflation: 1984 Yearbook,*** **R.G. Ibbotson Associates, Chicago, 1984.**

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SLIDE V

RATE OF RETURN EXPECTATIONS BY STATE AND LOCAL PENSION FUND OFFICIALS

Base: 126

	90-Day Treasury Bills	S&P 500 Stock Average	Established Growth Stocks	Emerging Growth Stocks	Buy-and-Hold Corporate Bonds	Actively Managed Corporate Bonds	Equity Real Estate	Real Estate Mortgages
Mean	8.9%	12.5%	14.3%	15.9%	10.0%	11.4%	12.0%	10.7%
Median	8.8%	11.5%	13.5%	15.5%	9.8%	11.5%	10.5%	11.5%

Source: Greenwich Research Associates, *Public Pension Funds 1984 Market Dynamics Report.*

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ADJUSTED BASIS. THAT IS TO SAY, AS AN ACTIVE MANAGER OR A BOARD MEMBER OF THE NEW CIVIL SERVICE RETIREMENT SYSTEM, I WOULD HAVE A VERY LARGE PORTION OF THE FUND INVESTED IN BONDS TODAY, BUT WOULD ARGUE STRONGLY FOR THE FLEXIBILITY TO CHANGE ASSET MIX AS INVESTMENT OPPORTUNITIES CHANGE.

THE SIGNIFICANCE OF THE HISTORICAL AND PROSPECTIVE RETURNS REALIZED BY VARIOUS INVESTMENT ALTERNATIVES ARE THE FOLLOWING:

1. COMMON STOCKS AND CORPORATE BONDS HAVE IN THE PAST, AND WILL PROBABLY IN THE FUTURE, OFFER HIGHER LONG-TERM RETURNS THAN TREASURY BILLS OR LONG-TERM GOVERNMENT BONDS.

2. THE SHORT-TERM VOLATILITY OF STOCKS IS SIGNIFICANTLY GREATER THAN BONDS OF ALL TYPES.

3. ALL INVESTMENT ALTERNATIVES HAVE ACHIEVED POSITIVE NOMINAL RETURNS OVER ANY TWENTY-YEAR PERIOD. HOWEVER, ONLY STOCKS HAVE SHOWN POSITIVE REAL RETURNS FOR EVERY TWENTY-YEAR PERIOD SINCE 1925.

4. THE VAST MAJORITY OF TWENTY-YEAR PERIODS SHOWED POSITIVE NOMINAL AND REAL RETURNS FOR ALL INVESTMENT ALTERNATIVES.

SINCE, AS MENTIONED EARLIER, A LONG-TERM TIME HORIZON IS APPROPRIATE FOR THE FEDERAL RETIREMENT SYSTEM, IT IS MY STRONGLY HELD OPINION THAT A PROPERLY DIVERSIFIED INVESTMENT PORTFOLIO UTILIZING A FULL ARRAY OF PRUDENT INVESTMENT ALTERNATIVES WILL ACHIEVE MUCH HIGHER INVESTMENT RETURNS THAN ANY OTHER APPROACH. ADDITIONALLY, THE HIGHER RETURN CAN AND SHOULD BE ATTAINED WITH MINIMAL INCREASE IN LONG-TERM VOLATILITY. THE ABOVE CONCLUSIONS ASSUME A PASSIVE INVESTMENT APPROACH, OBVIOUSLY ACTIVE MANAGEMENT OF THE RETIREMENT SYSTEMS ASSETS HAS THE POTENTIAL TO ENHANCE OVERALL RETURNS EVEN FURTHER.

AN ACTIVELY MANAGED INVESTMENT APPROACH UTILIZING ALL INVESTMENT ALTERNATIVES, FROM TREASURY BILLS AND BONDS, TO GOVERNMENT AGENCY AND CORPORATE BONDS, TO MORTGAGES AND REAL ESTATE TO THE FULL ARRAY COMMON STOCKS IS THE APPROACH THAT BEST ANSWERS THE QUESTION I POSED EARLIER WHICH WAS "WHAT INVESTMENT POLICY IS BEST SUITED TO PROVIDING APPROPRIATE RETIREMENT BENEFITS TO FEDERAL RETIREES AT THE LEAST COST TO THEIR EMPLOYER AND CURRENT PARTICIPANTS, AT AN ACCEPTABLE LEVEL OF RISK?"

THIS IS WHY MOST MAJOR CORPORATE UNION AND PUBLIC SECTOR PENSION PLANS HAVE MOVED TO SUCH AN APPROACH OVER THE PAST TWENTY YEARS OR SO.

THRIFT PLAN

THE SECOND MAJOR ELEMENT OF THE PROPOSED ACT THAT HAS INVESTMENT IMPLICATIONS IS THE CREATION OF A CAPITAL ACCUMULATION OR THRIFT PLAN AS AN ADJUNCT TO A DEFINED BENEFIT PLAN.

THE IMPORTANT INVESTMENT CONSIDERATION IS THE RECOGNITION THAT IN A DEFINED BENEFIT PLAN THE ASSETS OR LIABILITIES ARE, IN ESSENCE, OWNED BY THE EMPLOYER (OR IN THE CASE OF GOVERNMENT SYSTEMS, THE TAXPAYERS) WHO THEREFORE WILL REALIZE THE BENEFITS OF SUPERIOR INVESTMENT RETURNS AND ALSO BEAR THE COST OF INADEQUATE RESULTS AND/OR INSUFFICIENT CONTRIBUTIONS. IN THRIFT PLANS, ON THE OTHER HAND, THE EMPLOYEE OWNS THE ASSETS AND ASSUMES THE RISK AND REWARDS OF THE INVESTMENT RETURNS REALIZED. THE MAJOR INVESTMENT IMPLICATION OF INCLUDING A THRIFT PLAN IS THAT USUALLY EMPLOYEES ARE OFFERED A CHOICE OF INVESTMENT ALTERNATIVES AND MAY TAILOR THEIR INVESTMENT MIX TO SUIT THEIR PERSONAL FINANCIAL SITUATION AND RISK TOLERANCE. A YOUNGER EMPLOYEE, WITH HIGH POTENTIAL FOR CAREER ADVANCEMENT, MAY WISH TO HAVE A HIGHER PORTION OF ASSETS INVESTED IN COMMON STOCKS OR REAL ESTATE, WHEREAS, ANOTHER EMPLOYEE WHO IS CLOSER TO RETIREMENT, MAY WISH TO HAVE PLAN ASSETS INVESTED IN MORE CONSERVATIVE GOVERNMENT BONDS OR TREASURY BILLS. EITHER INDIVIDUAL COULD HAVE THE FREEDOM TO CHANGE THE MIX OF ASSETS IN THEIR PLAN AS PERSONAL FINANCIAL SITUATIONS CHANGE.

SINCE THE EMPLOYEE AND RETIREE HAS THIS FLEXIBILITY, THERE WILL OBVIOUSLY BE A NEED TO PROVIDE A VARIETY OF INVESTMENT CHOICES AND THE PROPOSED LEGISLATION DOES SO. THE THREE CHOICES PROVIDED ARE ENTIRELY APPROPRIATE - AT LEAST AT THE OUTSET. WHILE I PERSONALLY BELIEVE THAT THE COMMON STOCK FUND SHOULD CONTAIN BOTH A PASSIVELY MANAGED OR INDEXED PORTION AND AN ACTIVELY MANAGED SEGMENT, I CAN FULLY APPRECIATE THE POLITICAL AND COST REASONS TO UTILIZE ONLY AN INDEX FUND. IN THIS CASE, I WOULD STRONGLY SUGGEST THAT FIXED INCOME FUND FOLLOW A SIMILAR APPROACH.

ONCE THE MAJOR ISSUES OF INVESTMENT APPROACH AND PLAN STRUCTURE ARE RESOLVED, SOME OF THE TOUGHEST HURDLES STILL REMAIN. THESE ARE WHAT I CALL THE STRUCTURAL, POLITICAL AND POLICY ISSUES.

STRUCTURAL ISSUES

TAKING THE STRUCTURAL ISSUES FIRST, IT IS CLEARLY IN THE BEST INTEREST OF ALL CONCERNED TO SET UP THE CIVIL SERVICE THRIFT INVESTMENT BOARD IN SUCH A WAY AS TO PROVIDE THE MOST PROFESSIONAL UNDERSTANDING OF PENSION AND INVESTMENT ISSUES. THERE IS AMPLE PRECEDENT FOR THE ESTABLISHMENT OF SUCH A BOARD TO BE FOUND IN MANY OF THE STATE SYSTEMS IN THIS COUNTRY, AS WELL AS A NUMBER OF MULTI-NATIONAL EMPLOYERS SUCH AS THE UNITED NATIONS.

WHEN I PREVIOUSLY TESTIFIED ON AN EARLIER VERSION OF S. 1527, IT WAS

MY VIEW THAT THE BOARD SHOULD CONSIST OF EMPLOYEE, EMPLOYER AND POLITICAL REPRESENTATIVES AND SHOULD ASSUME BROAD POLICY MAKING AND OVERSIGHT RESPONSIBILITIES INCLUDING:

- INVESTMENT POLICY FORMULATION.
- ASSET ALLOCATION.
- LEGAL AND CONTRACTUAL OVERSIGHT.
- HIRING THE EXECUTIVE DIRECTOR.

THE ESTABLISHMENT OF A THRIFT ADVISORY COMMITTEE IS A VERY APPROPRIATE WAY TO PROVIDE PROFESSIONAL INVESTMENT INPUT.

AT THAT TIME, I FELT THAT CONTRARY TO THE PROVISIONS OF THE PROPOSED ACT, THE EXECUTIVE DIRECTOR SHOULD BE HIRED BY THE BOARD AND THAT EMPLOYEES, BOTH CURRENT AND RETIRED, SHOULD HAVE BROADER REPRESENTATION ON THE BOARD.

THE CURRENT LEGISLATION FULLY ADDRESSES THESE CONCERNS. ONE OF THE MOST IMPORTANT STRUCTURAL ISSUES TO BE FACED IS WHETHER THE FUND'S ASSETS SHOULD BE MANAGED BY A PROFESSIONAL, INTERNAL STAFF OR BY EXTERNAL INVESTMENT MANAGERS. THERE ARE PRO'S AND CON'S IN EACH APPROACH, AND AS YOU CAN SEE IN THE FOLLOWING TABLE (SLIDE VI), PUBLIC FUNDS IN THE U. S.

SLIDE VI

HOW MANAGEMENT OF PUBLIC FUNDS VARIES WITH FUND CHARACTERISTICS

	Base	Internal Management	Advisory Management	Discretionary Management
Type of Fund				
State funds	(70)	70%	49%	46%
Municipal funds	(170)	42%	32%	66%
Large municipal	(36)	47%	56%	61%
Plan Assets				
Over $500 million	(68)	69%	50%	49%
Type of Management				
Internal	(32)	100%	0%	0%
Advisory	(26)	0%	100%	0%
Discretionary	(79)	0%	0%	100%
Number of Employees				
Over 20,000	(63)	65%	44%	52%

SOURCE: Greenwich Research Associates, *Public Pension Funds 1984 Market Dynamics Report.*

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USE BOTH INTERNAL AND EXTERNAL MANAGEMENT ON BOTH AN ADVISORY AND DISCRETIONARY BASIS. MANY MAJOR FUNDS CONTRACT OUT MANAGEMENT OF CERTAIN ASSETS ESPECIALLY THE MORE COMPLEX INVESTMENTS SUCH AS STOCKS AND REAL ESTATE, WHILE RETAINING INTERNAL MANAGEMENT FOR SHORT-TERM INVESTMENTS AND PERMANENT LONG-TERM INVESTMENTS.

EVEN THOUGH I HAVE A BIAS TOWARD PROFESSIONAL, EXTERNAL MANAGEMENT BECAUSE OF THE CRITICAL IMPORTANCE OF ATTRACTING AND RETAINING AN OUTSTANDING INVESTMENT STAFF, I BELIEVE THAT A FUND AS LARGE AS THE FEDERAL GOVERNMENT RETIREMENT SYSTEM COULD VERY WELL FIND IT COST EFFECTIVE TO PERFORM CERTAIN INVESTMENT FUNCTIONS ITSELF, AND IN ANY EVENT, SHOULD HAVE A HIGHLY COMPETENT INVESTMENT PROFESSIONAL AS EXECUTIVE DIRECTOR. YOUR LEGISLATION PROVIDES FOR THIS.

POLITICAL AND POLICY ISSUES

IN ORDER FOR THE FUND TO BE BEST ABLE TO ACHIEVE ITS LONG RANGE OBJECTIVES FOR ITS PARTICIPANTS, IT IS PARAMOUNT THAT THE EXECUTIVE DIRECTOR, THE PROFESSIONAL STAFF AND EXTERNAL MANAGERS BE AS FAR REMOVED FROM POLITICAL INFLUENCE AND INTERFERENCE AS POSSIBLE. THERE ARE TOO MANY EXAMPLES, EVEN IN THE VERY RECENT PAST WHERE BOARD MEMBERS OR OTHER OUTSIDE GROUPS INTRUDED INTO THE INVESTMENT PROCESS OF PUBLIC FUNDS WITH QUITE NEGATIVE RESULTS.

THIS IS NOT TO SAY THAT SUCH POLICY/POLITICAL ISSUES SUCH AS "SOCIAL INVESTING", I.E. HOUSING STIMULUS, URBAN REVITALIZATION, SOUTH AFRICA ETC. ARE NOT LEGITIMATE CONSIDERATIONS FOR THE BOARD. THEY ARE. HOWEVER, IT MUST BE RECOGNIZED THAT VIRTUALLY EVERY INVESTMENT POLICY DECISION HAS THE POTENTIAL TO IMPACT THE RETURN AND/OR RISK REALIZED ON THE FUND'S INVESTMENTS, AND THEREFORE, THE BOARD MUST ADDRESS THESE ISSUES WITH THE INTEREST OF THE RETIREMENT SYSTEM'S CONTRIBUTORS AND BENEFICIARIES CLEARLY IN MIND.

IN NO EVENT SHOULD THE BOARD MEMBERS OR ANYONE ELSE OTHER THAN THOSE SPECIFICALLY VESTED WITH THE PROPER AUTHORITY HAVE THE ABILITY TO MAKE INVESTMENT DECISIONS. THE PROPOSED ACT HAS ADDRESSED THIS ISSUE QUITE PROPERLY.

ANOTHER MAJOR POLICY CONCERN IS THE POSSIBILITY THAT THE FUND MIGHT CONTROL THE MARKET OR CERTAIN SECTORS OF THE MARKET.

IN MY OPINION, THESE FEARS ARE WHOLLY UNFOUNDED. IN THE FIRST PLACE, THE PROPOSED ACT PROVIDES FOR A VERY GRADUAL PHASE IN THE PRIVATE SECTOR INVESTMENTS. SECONDLY, THE CURRENT AND PROSPECTIVE SIZE AND LIQUIDITY OF THE U. S. FINANCIAL MARKETS MAKE IT HIGHLY UNLIKELY THAT ANY RESPONSIBLY MANAGED FUND, EVEN ONE OF THIS SIZE COULD HAVE UNDUE INFLUENCE ON THE MARKET. THIRDLY, IT IS HIGHLY LIKELY THAT THE FUND'S ASSETS WILL BE

WIDELY DIVERSIFIED AMONG GOVERNMENT AND CORPORATE BONDS, REAL ESTATE, MORTGAGES AND A LARGE NUMBER OF COMMON STOCKS, NOT CONCENTRATED IN ANY ONE SEGMENT.

ON THE SURFACE, IT APPEARS THAT THE MULTIPLICITY OF STRUCTURAL, POLITICAL AND POLICY ISSUES AFFECTING THE FUND'S INVESTMENT APPROACH ARE SO COMPLEX AND CONTROVERSIAL THAT IT WOULD BE EASY TO CONCLUDE THAT IT'S JUST NOT WORTH UNDERTAKING MAJOR CHANGE. WE MUST REMEMBER, HOWEVER, THAT THERE IS A RESPONSIBILITY TO CURRENT AND FUTURE RETIREES THAT IS PARAMOUNT. MOST OF AMERICA'S MAJOR CORPORATIONS, OUR 50 STATES, MOST OTHER MAJOR POLITICAL SUBDIVISIONS AND OUR LARGEST LABOR UNIONS HAVE ALREADY CHOSEN A COURSE THAT UTILIZES MODERN INVESTMENT MANAGEMENT APPROACHES AND PRIVATE SECTOR INVESTMENTS.

THEY HAVE DONE SO BECAUSE IT IS IN THE LONG-TERM BEST INTEREST OF THEIR CURRENT, FUTURE AND RETIRED EMPLOYEES. YOUR PROPOSAL PROVISION OF A THRIFT PLAN WITH A CHOICE OF INVESTMENT ALTERNATIVES IS A VERY BENEFICIAL PROVISION FOR FEDERAL WORKERS--CURRENT AND FUTURE.

FOR THE EMPLOYEE, IT PROVIDES THE OPPORTUNITY TO TAILOR THEIR RETIREMENT PROGRAMS TO THEIR INDIVIDUAL NEEDS, AND TO ADJUST THE INVESTMENT MIX IN THEIR ACCOUNT TO REFLECT CHANGING PERSONAL FINANCIAL CIRCUMSTANCES. ADDITIONALLY, THE CONTRIBUTIONS TO EACH EMPLOYEE'S

INDIVIDUAL THRIFT ACCOUNT WILL BE OWNED BY THE EMPLOYEE, WILL BE PORTABLE IN THE EVENT THE EMPLOYEE CHANGES JOBS, AND WILL THEREFORE BE INSULATED FROM POLITICAL OR BUDGETARY UNDERMINING.

WHILE IT IS TRUE THAT THE INVESTMENT RISK AS WELL AS THE REWARD OF THE INVESTMENT RESULTS ARE BORNE BY THE EMPLOYEE IN THE THRIFT PLAN, IT IS ALSO TRUE THAT THE PLAN PROVIDES A LOW RISK INVESTMENT ALTERNATIVE. FURTHERMORE, AS DISCUSSED EARLIER, IT IS HIGHLY LIKELY THAT THE LONG-TERM RETURNS FROM A PROFESSIONALLY MANAGED, WELL DIVERSIFIED FUND WILL EXCEED THE RETURNS FROM AN UNMANAGED FUND INVESTING ONLY IN SPECIAL TREASURY ISSUES. THIS IS NOT ONLY BECAUSE RETURNS FROM OTHER INVESTMENTS WILL, IN ALL LIKELIHOOD CONTINUE TO BE HIGHER OVER LONG TIME PERIODS, BUT EQUALLY IMPORTANT, BECAUSE ASSET MIX CAN BE ALTERED TO REFLECT ECONOMIC, MARKET, INFLATIONARY AND INTEREST EXPECTATIONS.

IN CONCLUSION, THE PROPOSED CIVIL SERVICE PENSION REFORM ACT IS AN IDEA WHOSE TIME IS LONG OVERDUE. IT WILL GO A LONG WAYS TOWARD BRINGING THE FEDERAL RETIREMENT SYSTEM INTO THE MODERN AGE. SOME OF THE SHORT-TERM POLITICAL HURDLES WILL BE TOUGH TO OVERCOME, BUT A GOOD START IS BEING MADE AND THE LONG-TERM BENEFITS SHOULD BE OBVIOUS TO ALL CONCERNED.